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August 29, 2005

<u>EX PARTE</u>

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: *Inter-Carrier Compensation for ISP-Bound Traffic*, CC Docket No. 99-68;

Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92;

Core Communications Petition for Forbearance, WC Docket No. 03-171

Dear Ms. Dortch:

BellSouth Corporation ("BellSouth") submits this response to a recent letter from John T. Nakahata, counsel for Level 3 Communications, regarding the above-referenced proceedings.[1] In his letter Mr. Nakahata makes several representations about a presentation made to the NARUC Intercarrier Compensation Task Force ("Task Force") by Dr. Robert Blau, Vice President for Public Policy Development for BellSouth, at a meeting in Austin, Texas on July 23, 2005. Mr. Nakahata's letter is inaccurate, and BellSouth is compelled to set the record straight.

By way of background, Dr. Blau was asked by the Task Force to address the claims of some participants that dial-up Internet access will soon be so thoroughly supplanted broadband services that Task Force need not address the issue of intercarrier compensation for dial-up ISP calls as part of its intercarrier compensation reform proposal.

Contrary to Mr. Nakahata's claims, the chart that Dr. Blau presented, a copy of which is attached as Exhibit 1, shows that dial-up subscribers would continue to generate substantial minutes of dial-up ISP calls, notwithstanding projections of a continued decline in the number of dial-up subscribers. Those minutes, moreover, would translate into extremely large and uneconomic payments from incumbents to managed modem providers like Level 3, if proposals

[1] Ex Parte Letter from John T. Nakahata, Counsel for Level 3 Communications, to Marlene Dortch, Secretary, FCC (August 3, 2005) ("*Level 3 Ex Parte*").

(like Level 3's) were adopted that would return to a regime where dial-up ISP calls are treated as if they are equivalent to local voice calls.[2] This chart, therefore, does not in any way contradict a chart that BellSouth submitted in these dockets on October 1, 2004.[3] Indeed, it corroborates BellSouth's earlier submission.

Specifically, the chart presented by Dr. Blau to the Task Force depicts the number of U.S. households that IDC, a well-known market research firm, expects to continue accessing the Internet through dial-up modem connections during the 2005-2009 timeframe. The chart, like the October 1, 2004 chart BellSouth submitted to the Commission, shows a projected continuing decline in dial-up ISP subscribership, as more customers switch to broadband services.[4]

The chart also is based on data compiled by the Harris Nesbitt company, another market research firm, which measures Internet usage among U.S. households. These data indicate that households that currently access the Internet through dial up modem connections use the Internet an average of seven hours or 420 minutes per week. Projections of Internet usage by dial-up ISP customers through 2009 were based on an assumed average annual increase of 5 percent. This is a very conservative estimate given past trends. It was selected as it demonstrates the continued need for the Task Force to address dial-up ISP traffic while avoiding debates about the validity of the projection, given that several other presentations were made at the Task Force meeting and the time allotted for discussion was limited.

The chart also contains calculations of the total potential payment obligation for incumbents. The calculations were based on the $0.0007 rate that currently applies under the *ISP Remand Order* and a $0.003 rate, which according to Fulcrum Global Partners represents the rough average rate applicable to local voice traffic under existing interconnection agreements.[5] The higher rate provides an indication of the potential payments available to companies like Level 3 in the event that the Commission were to accept their position that the 1996 Act requires incumbents to pay reciprocal compensation for ISP-bound calls as if they were no different from local voice calls.

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[2] Dr. Blau also presented a chart from a June 20, 2004 report on Level 3 Communications prepared by securities analysts at Fulcrum Global Partners. A copy of that report is attached as Exhibit 2. Page 7 of that report contains the chart which distinguishes symmetrical compensation arrangements, such as for local voice calls, and asymmetrical arrangements, such as for dial-up ISP traffic, where the "managed modem provider (Level 3) never has to pay the LEC."

[3] *See* Letter from Herschel L. Abbott, Jr., BellSouth, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-171, CC Docket Nos. 99-68 & 96-98 (Oct. 1, 2004); *see also* Letter from Bennett L. Ross, BellSouth, to Marlene H. Dortch, Secretary, FCC, CC Docket Nos. 99-68 & 96-98 (Dec. 17, 2004) (providing an erratum correcting "an error in [BellSouth's] description of th[e] study" it had submitted in the October 1, 2004 ex parte).

[4] Notwithstanding Mr. Nakahata's suggestion to the contrary (*Level 3 Ex Parte* at 1), BellSouth has never disputed that the number of dial-up subscribers is declining and that the number of broadband subscribers is increasing. For purposes of the question the Task Force asked, however, the number of subscribers is irrelevant, because the problems associated with intercarrier compensation for ISP-bound calls are related to the total number of *minutes* of such calls, not the number of *people* placing such calls.

[5] *See* Exhibit 2 at 7.

Mr. Nakahata claims that the fact the chart shows potential payments falling from 2005 through 2009 undermines the data in the chart BellSouth submitted on October 1, 2004.[6] Mr. Nakahata is wrong. The October 1, 2004 chart showed that dial-up ISP traffic was projected to remain above 2001 volume levels until 2007. The chart Dr. Blau presented to the Task Force, however, contains no information for any year before 2005.

Nonetheless, the chart supports an inference that — as BellSouth previously showed the Commission — dial-up ISP minutes remain at or above 2001 levels and are projected to stay at or above those levels for a number of years. Specifically, the chart estimates that potential intercarrier payments — absent the rate caps, growth caps, and the new markets rule that the Commission adopted in the *ISP Remand Order* — are currently nearly $3 billion annually and will remain in excess of $2 billion annually through 2008. At the time of the *ISP Remand Order*, the Commission found that incumbents were paying nearly $2 billion annually for ISP-bound calls. *See ISP Remand Order* ¶ 5. Because reciprocal compensation rates in 2000-2001 were no lower than the $0.003 rate used to calculate potential payments, the chart Dr. Blau presented therefore suggests that dial-up minutes have increased, not declined, since 2001.

For these reasons, the two charts that BellSouth prepared are entirely consonant with each other. Both show that dial-up ISP traffic remains a significant arbitrage opportunity — and is projected to remain so for the next few years — despite declines in the number of dial-up ISP subscribers.

Please include a copy of this letter in the record in the above-referenced proceedings. Thank you for your attention to this matter.

Yours very truly,

Bennett L. Ross

BLR:kjw

Enclosure

#599305

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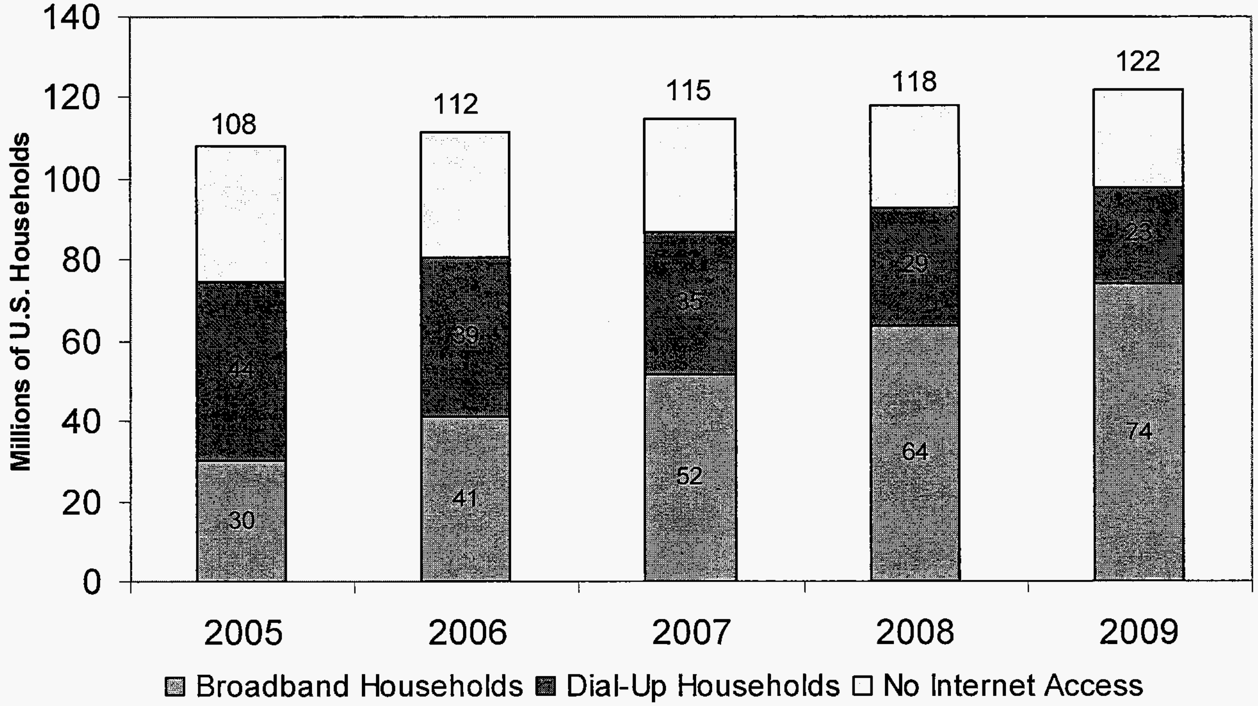
[6] *Level 3Ex Parte* at 2.

Exhibit 1

The Continuing Problem With Reciprocal Compensation For One-Way Dial-Up Internet Access



	2005	2006	2007	2008	2009
Minutes of Internet Use per Week per Dial-Up Household	420	441	463	486	511
Dial-Up Recip Comp Exposure ($ Millions)					
@$0.0007/minute	$677	$630	$592	$511	$435
@$0.003/minute	$2,903	$2,701	$2,538	$2,188	$1,864

Source: IDC and Harris Nesbitt estimates

Exhibit 2

fulcrum GLOBAL PARTNERS®

LVLT: 2Q04 Communications EBITDA 22% Overstated — SELL

Gregory P. Miller (212) 803-9024 gmiller@fulcrumgp.com
Chris Chapple (212) 803-7016 cchapple@fulcrumgp.com

Level 3 Comm. # (LVLT, $2.61, NASDAQ, SELL) **August 13, 2004**

Business Description: Level 3 Communications, Inc. is engaged primarily in the communications and information services businesses. The company is a facilities-based provider of integrated communications services. It has created the Level 3 Network, an advanced, international, facilities-based communications network, by constructing its own assets and also through a combination of purchasing and leasing of facilities.

#Fulcrum Global Partners LLC makes a market in this security.

Decision points:

- **2Q04 10-Q reveals even more inadequate disclosures** – With the report of the 2Q04, we reported to investors that Level 3 Communications beat our $77 million Communications estimate by $2 million. Because the company did not provide adequate disclosure at the time of the 2Q04 earnings release of the nature and magnitude of the one-time benefits, investors were led to believe the company had beaten expectations when in fact they fell well short.

- **Investors should thank the SEC for disclosure requirements** – With full disclosure of 2Q04 results to the SEC, it is clear to us that the earnings release overstated Communications EBITDA by nearly 22%, resulting in an investor perception (at the time of the report) that was entirely different from reality. Although the magnitude of the overstatement was large on a relative basis, we believe it is the act itself which is far more damaging to the company's valuation. We believe that this consistent pattern of activity only further solidifies our belief that the outlook for this company might not be as attractive as has been suggested. We also believe that this type of activity resembles that of other similarly situated companies in our sector over the past few years that were in less of a position of financial or strategic strength.

- **Average investors can no longer follow the financials of Level 3,** in our opinion – From the guidance that doesn't match the GAAP reconciliation schedule, to the 3Q04 guidance that doesn't disclose the magnitude of expected similar one-time items, to the lack of disclosure of one-time benefits booked in the quarter, the second quarter earnings release can be described as the most confusing quarter for investors for any company that we have ever covered. It is our opinion that the average professional investor can no longer invest time or resources in trying to understand the financials of this company.

- **For the company to have "option value" one must believe in the concept alone and forget entirely the details of the company** – Although we completely agree with the concept that we will ultimately consume the majority of the bandwidth in the market, we cannot forget the micro details of investing in any one of the given companies that could stand to benefit from such trends, if we ever see such a change in our lifetime. Accordingly, the only way we could ever warm to shares of Level 3 would be to entirely forget about these details that we have consistently been presented with over the course of the past year, details that confirm to us that the perception surrounding the company's performance and prospects are entirely different from reality.

Important disclosures and analysts' certifications appear in Appendix B

- **Company conference calls continue to become increasingly irrelevant** – We believe that the course of events on this most recent Level 3 conference call, in addition to a host of other companies' in the sector, again demonstrates just how irrelevant quarterly conference calls are and how important it is for investors to read the finite details of the company's (and related companies') SEC filings. For Level 3, without them, one would be left with the impression that 1. the most recent quarter was ahead of expectations, 2. that the AOL issue was really a surprise, 3. that the company is adequately positioned for the coming migration from dial-up to broadband, and 4. that reported margin differences are "normalized" at the EBITDA level and therefore comparable to peers for cost structure comparisons. We believe that SEC filings have suggested a very different assessment of those four situations that are only now being realized by many investors.

- **Valuation is still very high** – Still priced at nearly 27x recurring adjusted 2005 EBITDA estimates, Level 3 Communications remains the most overvalued stock in the entire universe of telecommunications services stocks, in our opinion. Priced at 16.7x 2005 estimated Consolidated (total company) EBITDA estimates (including all of the noise), we believe the stock should generously trade at $1 per share. We note that if we left our long-standing 12.0x multiple on the new 2005 EBITDA estimates, it would yield a negative $1.20 price target.

Rating:	**SELL**	**FY: Dec**	**2003**	**A**	**2004**	**E**	**2005**	**E**
Price:	**$2.61**	**Mar**	**$0.22**	**A**	**($0.22)**	**A**	**--**	
52-Week Range:	**$2.53 - $7.40**	**Jun**	**(0.95)**	**A**	**(0.09)**	**A**	**--**	
Market Capitalization:	**$1.77 billion**	**Sep**	**(0.38)**	**A**	**(0.28)**	**E**	**--**	
Avg. Daily Volume:	**7.4 million**	**Dec**	**(0.19)**	**A**	**(0.28)**	**E**	**--**	
Dividend Per Share/Yield:	**$0.00 / 0.0%**	**Full Year**	**($1.28)**	**A**	**($0.87)**	**E**	**($1.35)**	**E**
3-yr Est. Grwt Rate:	**NM**	**Previous**	**--**		**($1.90)**		**($1.32)**	
		Consensus			**($1.11)**	**E**	**($1.07)**	**E**
Target Price	**$1.00**	**P/E**	**NM**		**NM**		**NM**	
Risk Level	**Medium**	**Revenue (mm)**	**$4,053**	**A**	**$3,697**	**E**	**$3,374**	**E**

10-Q Filing Reveals Disappointing Details

Details indicate deteriorating position – With the release of the Level 3 10-Q and the surprising recognition that the company booked two separate one-time gains in 2Q04 that they failed to disclose to investors in the 2Q04 earnings release or on the associated conference call, we believe it is increasingly clear that the operating model is under increasing pressure. Otherwise, we cannot envision a scenario whereby one of the more credible management teams of this segment of the industry would break from a long-standing tradition and force investors to sift through SEC documentation to discover what the real EBITDA result actually was. Accordingly, it is now clear that Communications EBITDA for 2Q04 (the only relevant segment of the company) was a mere $65 million and not the reported $79 (assuming that we use the company's generous definition of EBITDA). With reported Communications EBITDA overstated by nearly 22% without disclosure, and with the outright refusal to answer questions related to 3Q04 ISP-bound reciprocal compensation settlements (the driver of the gains 2Q04), investors are left to guess just what the recurring Communications EBITDA result (excluding expected one-time benefits) will look like in 3Q04. With such an overhang on the stock and with the AOL overhang continuing and lacking any clarity on whether or not the elusive government contracts will remotely offset organic declines in legacy business, we are now beginning to question the longevity of the company beyond 2005.

Big numbers, bigger lack of disclosure – Although the numbers are big, it's the lack of disclosure that is more important, in our opinion. Providing the perception that the all-important Communications EBITDA estimate that the company provided to investors has been met and even exceeded, when in fact the company fell short by a significant margin (excluding the non-recurring gains), is a bigger offense, in our opinion. Further, even though the 22% overstatement of the company's traditional definition of Communications EBITDA was surprising for a company that was once viewed to have a higher degree of credibility than many other emerging telecommunications services companies, it is even more alarming given that it appears that the company plans to do the exactly the same in 3Q04, as was hinted in the 2Q04 earnings release when discussing what otherwise appeared to be a prediction of organic growth in 3Q04 that in reality was likely nothing more than an attempt to squeeze those who have sold the stock short.

Where have we witnessed this type of activity before? – For those who have not been following the industry through its ups and downs over the course of the past ten years as we have, all we can say is that the act of failing to disclose significant material events to shareholders during the course of conference calls while quietly putting the relevant disclosures deep within SEC filings, or not at all, reminds us of companies like WinStar Communications in the final quarters up to the time in which the company filed for Chapter 11 bankruptcy. Although the results that WinStar presented appeared relatively attractive in any one given quarter, it did not take long for analysts to determine that what they were provided with was not an accurate representation of the company's health. In fact, much like that of Level 3, analysts and investors alike were left to sift through the SEC filings of other companies to see what was actually happening with Winstar during any given quarter. Had the Winstar bankruptcy happened following WorldCom or Enron, we suspect that it too would have been met with a US Department of Justice and SEC investigation of its own. Fortunately for some investors in the equity and debt, at least one analyst had the foresight (or luck) to predict when WinStar Communications had reached the point of no return when the stock was still in the low single digit range.

As defined by the company, it would appear as if 2004 expectations will be difficult to meet – Even though we have not traditionally evaluated Level 3's performance on the basis of how the company reports Communications EBITDA (by including recurring reciprocal compensation payments and excluding non-cash compensation payments and other one-time benefits), we do clearly recognize that some investors choose to do so. With that in mind, we doubt that such investors are suddenly about to change the definition of EBITDA to include non-recurring items such as reciprocal compensation settlements or even one-time property tax benefits that the company has previously disclosed in prior earnings releases. Given that it is virtually impossible to tell what is included in "settlement revenues" with RBOCs such as BellSouth and others, we believe it would be foolish to think that such payments merely represent the past two quarters of billed (but not booked) ISP-bound reciprocal compensation payments. If done in tandem with a services or transport purchase, BellSouth Corp. might simply view the $10 million payment as a prepayment on cheap transport services. Because the term “settlement” can mean just about anything, we would strongly advise against assuming that a bulk payment of this type within the year simply normalizes otherwise lumpy quarters by the end of the year. Therefore, by backing out these two non-recurring items from the company’s newest version of EBITDA (as of 2Q04) as well as the non-recurring property tax benefits, it is fairly clear that the company will need both a substantial improvement in revenue and EBITDA in the fourth quarter to meet its guidance. There has been much discussion of a large government contract or VoIP contract with Comcast that will lead to growth in the latter part of the year – although the company has yet to announce such a contract, nor have they quantified the expected revenue contribution. However, we estimate the company will need in excess of $170 million in annualized contract value to show positive y/y revenue growth in the fourth quarter (excluding settlement / termination revenue and the ICG contribution of ~$35 million). Assuming the full impact of the AOL 33% port disconnect hits by the fourth quarter, we estimate they will need lose ~$18 million in Softswitch revenues from 2Q levels (assumes 300k ports at $20 / port / month). Further, if we assume IP & Data is only up marginally, that “recurring” reciprocal compensation is $16 million, and that there are no further reciprocal compensation settlements, we estimate the company will need $43 million in revenue from new business to show positive y/y growth in the fourth quarter.

Figure 1.

- **Although *NOT* our forecast, the table below is meant to demonstrate what we estimate the revenue contribution from new contracts and business in the fourth quarter will need to be in order for the company to meet their “guidance.”**

What they need to still meet guidance (with "EBITDA" as defined by Level 3)

	2003	1Q04	2Q04	3Q04E	4Q04E	2004E
Transport & infrastructure	$433	$115	$116	$120	$163	$514
Softswitch (excluding est. ICG contribution)	644	141	134	128	115	519
IP & Data	397	103	101	99	102	406
Recurring Communications revenue	**1,474**	**359**	**351**	**348**	**380**	**1,439**
"Recurring" reciprocal compensation	127	23	16	16	16	71
Reciprocal compensation settlement revenue	0	0	10	25	0	35
"Guidance" revenue	**1,601**	**382**	**377**	**389**	**396**	**1,545**
y/y growth %		*0.8%*	*-10.8%*	*-3.5%*	*0.1%*	*-3.5%*
Settlement / termination	346	7	2	5	5	19
Estimated ICG revenue	0	0	12	12	12	35
Total Communications revenue	**1,947**	**389**	**391**	**406**	**413**	**1,599**
Reported EBITDA		116	79	110	123	**428**
margin %		*29.8%*	*20.2%*	*27.1%*	*29.8%*	*26.8%*
Less: property tax benefit		0	(4)	0	0	(4)
Less: reciprocal compensation settlement		0	(10)	(25)	0	(35)
Adjusted Communications EBITDA		**116**	**65**	**85**	**123**	**389**
margin %		*29.8%*	*16.6%*	*21.0%*	*29.8%*	*24.3%*

If we assume the full AOL port disconnect has fully hit by 4Q, roughly 300k ports at $20 / port should cause 4Q Softswitch revenues (excluding ICG) to be ~$18 mln less than 2Q revenues.

Therefore, if we assume marginal growth in IP & Data, ***the company would need approximately $43 million ($172 million annualized) in new revenue*** in Transport & Infrastructure in 4Q to still meet revenue guidance of 4Q04 y/y growth.

Further, if we assume the mid-point of "Reported" EBITDA guidance for 3Q of $110 million (which includes settlement and termination revenue and reciprocal compensation settlements), they will need $123 million in "Reported" EBITDA to meet 4Q EBITDA margin guidance (high-20% range), full year Reported EBITDA margin guidance (mid-20% range), and still achieve a full year margin excluding benefits and settlements within their mid-20% guidance range.

Source: Company data and Fulcrum Global Partners estimates.

Current guidance:

- 4Q04 revenue (excluding settlement and termination revenue and the contribution from ICG of ~$35 million) should show positive y/y growth from 4Q03.
- Full year 2004 revenue (excluding settlement and termination revenue and the contribution from ICG of ~$35 million) will be down in the high-single digit percentage range. The company said on the second quarter conference call that they believe they will meet or exceed this guidance.
- Reported Communications EBITDA margins in the mid-20% range for 3Q04, high-20% range for 4Q, and mid-20% range for the full year.

Details of the benefits – Although the property tax benefit is relatively straightforward (as it was essentially a reversal of previously accrued property tax expense) the reciprocal compensation benefit is not as straightforward. On December 31, 2003 Level 3's interconnection agreement with BellSouth expired and it was at this time that it appears Level 3's revenue recognition policy with regards to reciprocal compensation changed. In the company's 2003 10-K, the company describes its revenue recognition policy as follows:

> *"Reciprocal compensation revenue is recognized only when an interconnection agreement is in place with another carrier, and the relevant regulatory authorities have approved the terms of the agreement. Periodically, the Company will receive payment for reciprocal compensation services before the regulatory authorities approve the agreement. These amounts are included in other current liabilities on the consolidated balance sheet until the Company receives the necessary regulatory approvals."*

However, in the 1Q04 10-Q (and also in the 2Q04 10-Q), the company's policy is described as follows:

> *"During these negotiations, Level 3 continues to bill the customers at previously contracted amounts, but is recognizing revenue at the FCC mandated rates. If the terms of the final contracts result in an interconnection rate higher than the FCC rate, Level 3 will recognize the incremental reciprocal compensation revenue at that time."*

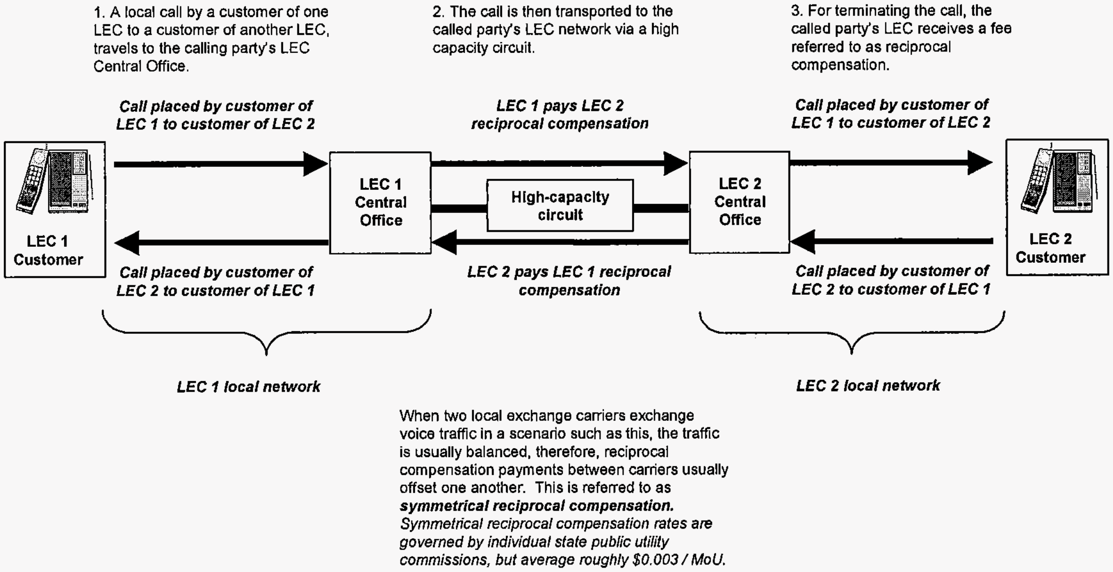
Therefore, based on this new policy, it would seem that Level 3 ***was*** booking (recognizing) reciprocal compensation revenue from BellSouth in the first quarter, but only at the FCC mandated rate ($0.0007 / MoU). Presumably, the recent agreement signed with BellSouth in the second quarter was at a rate higher than the FCC rate, and Level 3 therefore recognized this prior period "catch-up" revenue in the second quarter.

A BellSouth Interconnection agreement means little, in our opinion – If the recently struck interconnection agreement between BellSouth and Level 3 provided certainty beyond next week, we would fully expect to hear about it in one of the many press releases from Level 3. Over the course of history, Level 3 has traditionally announced to investors when a highly favorable interconnection agreement has been struck with an RBOC that has either extended such ISP-bound reciprocal compensation payments or for rates higher than is currently mandated by the FCC. In this case, we simply have the quiet disclosure that an agreement exists. To suggest unequivocally that the existence of such an agreement ensures certainty over the collection of reciprocal compensation payments to Level 3 from BellSouth for the next three years is one of the bigger disservices we could possibly do for investors in this stock. ***Anyone who has witnessed the demise of Talk America will clearly realize that interconnection agreements are almost always subject to changes in regulatory policy, as is the case with the interconnection agreement of the now-failed Talk America***. In our opinion, the completion of the more than five-year-long FCC effort to move ISP-bound traffic from the reciprocal compensation billing regime to the bill and keep billing regime would clearly represent the material change that would allow BellSouth to back out of any agreement to pay ISP-bound reciprocal compensation payments to Level 3 for the three year period. Accordingly, we doubt that the interconnection agreement (relating to ISP-bound reciprocal compensation), which is traditionally announced with great fanfare by Level 3, with BellSouth Corp. (the former employer of Level 3's 2003 Vice Chairman Charles Miller) is as solid as some are led to believe.

Just ask yourself the reasonable question: Why would BellSouth Corp. agree to pay more for nothing? The answer is simple: they would not. ISP-bound reciprocal compensation is compensation the RBOC must pay to a CLEC (Level 3 in this case) because the RBOC's local customer (residential dial-up Internet user) generates traffic that terminates on Level 3's network (managed modem port) when the customer dials into their Internet Service Provider (AOL, Earthlink, United Online, etc.). Because the RBOC is terminating this dial-up traffic on Level 3's network, they are currently required to compensate Level 3 for this termination service. Accordingly, with BellSouth having no control over the amount of dial-up traffic their customers generate, they would have no incentive to agree to pay Level 3 more than required by the FCC unless they were to receive something in return from Level 3. So, it is very likely that in return for allowing

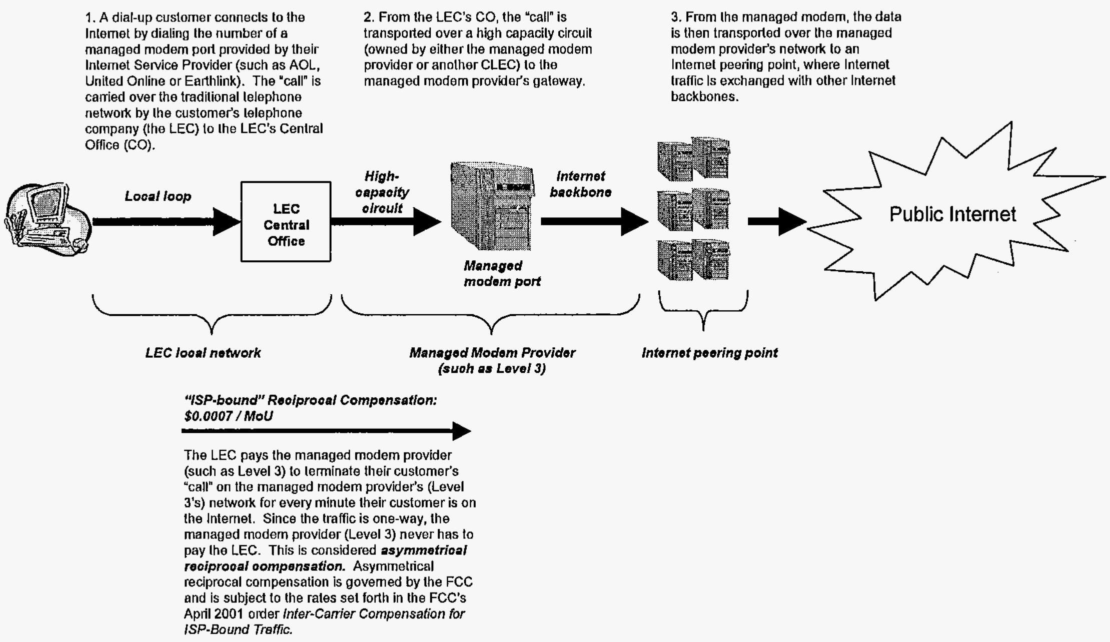
Level 3 to report some sort of "settlement" for billings that arguably had little legal standing at best (if they related to the difference between what Level 3 billed versus what they booked for ISP-bound reciprocal compensation) then BellSouth Corp. would have most certainly received some economic benefit in return. It could very well be that if BellSouth agreed to purchase discounted transport capacity from Level 3, the $10 million settlement essentially represented nothing more than a prepayment for such services. Without the details of the agreement it is impossible for anyone to suggest they know exactly what is going on. Further, to suggest that the company was collecting virtually no ISP-bound reciprocal compensation revenue from BellSouth (when they were at least booking revenue at the FCC-mandated rate) due to a lack of an interconnection agreement is simply wrong, as BellSouth would be required to pay at least the FCC-mandated rate for ISP-bound reciprocal compensation absent a formal interconnection agreement.

Figure 2. Traditional *symmetrical* reciprocal compensation arrangement between two carriers exchanging voice traffic



Source: Fulcrum Global Partners LLC.

Figure 3. *Asymmetrical* reciprocal compensation arrangement between two carriers exchanging dial-up ISP-bound traffic



Source: Fulcrum Global Partners LLC.

Be careful of misguided regulatory analysis – Once again we hear the suggestion that the issues relating to ISP-bound reciprocal compensation are inextricably tied to that of traditional reciprocal compensation between two telecommunications carriers, which is part of an issue with the group working on Intercarrier Compensation reform (the ICF). It would appear that some are attempting to suggest that because the greater intercarrier compensation issues will not be resolved until late 2005-2006, that the separate Intercarrier Compensation for ISP-bound Traffic Remand Order (currently on remand again since 2002) will not be resolved until that time as well. In so doing, we believe some investors have been misguided to believe that these two separate issues are one and the same and that the ISP-bound reciprocal compensation that Level 3 collects could be a stable source of revenue for the foreseeable future--we believe this could not be farther from the truth. We can only hope that such misguided analysis is not the result of companies or industry specialists feeding the information to the market, but we cannot say for sure. The ISP-bound Remand Order and the Intercarrier Compensation Forum (resulting from an FCC NPRM) remain two separate and distinct issues where the former requires a decision to be made by the FCC before October 14th of this year. Although there are many legal outcomes that could prevail in the case of the ISP-bound Remand Order, for us to suggest that we know which one will with certainty would be no different than to have suggested that we knew for a fact that the US Supreme Court would have heard the FCC's request for an appeal of the DC Circuit Court of Appeals TRO ruling--which some foolishly GUESSED wrong at. In short, we have historically found those who suggest that they know the definitive answer with respect to any given regulatory outcome to be of the most dangerous type of advisors to investors.

Organic reciprocal compensation was likely down dramatically anyway! For the first time in as many quarters as we have followed this stock, we have seen direct evidence that it simply does not matter what the FCC does later this year with the ISP-bound Remand Order and the likelihood that one third of Level 3's EBITDA vanishes with a stroke of a pen. When accounting for the $10 million one-time BellSouth gain in the quarter, in addition to assuming that the ICG Communications business produced $2-$3 million of ISP-bound reciprocal compensation in the quarter, we estimate that organic Level 3 ISP-bound reciprocal compensation declined by more than 40% organically (about $14 million recurring booked in 2Q). With the same type of one-time settlement expected in the third quarter (surprisingly, without disclosing to investors the expected magnitude), we suspect that the underlying trends of reciprocal compensation payments to Level 3 Communications will continue to trend downward. With such trends, it should now be apparent that it almost does not matter if the FCC concludes the five-year-long effort to rid the market of this regulatory inspired arbitrage; rather, it would appear as if the arbitrage is on its way out on its own. We suspect that the reason for such a dramatic organic decline is likely the aggressive migration of otherwise high-end dial-up users to broadband, leaving low-usage customers to continue generating the ISP-bound reciprocal compensation traffic.

So what does 3Q04 company guidance mean? With the company strongly implying in their 2Q04 earnings release and conference call that the gains in 3Q04 are to come as a result of ISP-bound reciprocal compensation settlement gains and yet with what appeared to be extreme reluctance to disclose the estimate of such gains, the upcoming quarter remains a mystery. In our opinion, given the state of the market, Level 3 will be lucky enough to hold its own against the increasingly desperate number of competitors in the non-managed modem segment of the business, which itself is in the state of advanced secular decline. Accordingly, if we generously assume that Transport & Infrastructure and IP & Data revenues remain relatively flat sequentially and assume SoftSwitch declines by a very conservative $6 million and we then make a further generous assumption that settlement and termination revenues increase from $2 to $5 million in the quarter, the ISP-bound reciprocal compensation settlement the company alludes to but does not clarify for the third quarter would have to be at least $25 million in order for the company to meet their coveted "guidance." In our opinion, the very fact that the company is relying upon such a one-time settlement to make the coming quarter appear as if they are "growing" is the strongest sign of weakness we can envision.

We finally have complete disclosure on "the welcome migration to broadband" – Since late last year, we have been warning investors that the pitch by the Level 3 management team that they welcome the migration from dial-up to broadband (cable modems and DSL) because the "revenue opportunity" can be twice as much as it is for dial-up was nothing more than a pitch designed to provide comfort to those believers who may have otherwise been worried that the company's legacy data business (managed modem, which is likely more than 95% of the company's SoftSwitch revenues) is in a state of advance accelerated declines. With the earnings report earlier this year, the company finally admitted that the Verizon DSL contract is up for renewal and that they "assume" an aggressive migration of the customer base off the Level 3 network. Curiously, this would leave the company that welcomes the migration from dial-up to broadband with very little of a broadband hedge. Therefore, as the dial-up subscriber base from AOL, Earthlink and others dwindle, the company would not be generating twice the revenue per subscriber as the migration took place. In fact, they would simply lose revenue on an otherwise fixed-cost network. From this disclosure, which was formalized in the most recent 10-Q, we expect to see the company, as well as other analysts, cease the fantasy suggestion that the company is adequately "hedged" to the erosion of the dial-up subscriber base. Once again, we believe it has been clearly demonstrated that the perception that was created for investors was far from reality.

Kevin O'Hara on 1Q04 conference call
"There's also speculation in the marketplace about the status of our DSL aggregation contract with Verizon. This contract was acquired as part of the Genuity transaction, and the specific terms of the contract are not public. However, both sides have the right to amend the contract beginning in the second quarter of 2005. The amendment right includes the ability to terminate the contract. While conservative, for planning purposes, we have assumed that the revenue ramps down in accordance with the contract terms and an aggressive migration plan. If the contract is terminated and all traffic migrates off, the revenue impact in 2005 is not material, as we estimate the total 2005 impact to be in the low single digits as a percentage of Communications revenue."

2Q04 10-Q

"The Company's DSL aggregation services are primarily provided to Verizon through a contract obtained in the Genuity transaction. This contract expires at the end of the first quarter of 2005. If Verizon transfers this traffic to its network in 2005, the reduction in DSL aggregation services revenue could represent a low single-digit percentage range decline in Level 3's communication revenue in 2005."

Raising 2004 estimates, but lowering 2005 estimates – As a result of the lower-than-expected AOL port disconnects in 2004 from what now appears to be a gradual port disconnect rather than a flash cut, expected reciprocal compensation settlement revenues in 3Q and higher settlement and termination revenue, we are raising our 2004 Communications revenue by $89 million to $1.573 billion and our Reported Communications EBITDA estimate by $21 million to $405 million. However, we are only raising our recurring Communications EBITDA estimate (which excludes reciprocal compensation, settlements / terminations, non-cash compensation expense and one-time items) by $4 million to $221. As a result of these changes, we are raising our Consolidated EBITDA estimate from $426 million to $457 million. For the first time, we are now factoring the loss of the Verizon DSL aggregation contract at the end of 1Q05 into our estimates. Largely as a result of this, we are lowering our 2005 Communications revenue estimate by $28 million to $1.272 billion and our Reported Communications EBITDA estimate by $41 million to $262 million and our recurring Communications EBITDA estimate (which excludes reciprocal compensation, settlements / terminations, and non-cash compensation expense) by $30 million to $224 million. As a result, we are also lowering our Consolidated EBITDA estimate by $31 million to $319 million.

Figure 4

Changes to 2004 and 2005 estimates

	2004			2005		
	Previous	**New**	***Difference***	**Previous**	**New**	***Difference***
Operating revenue:						
Transport & infrastructure	$465	$474	*$10*	$480	$482	*$1*
Softswitch	495	554	*58*	414	433	*19*
IP & Data	402	406	*4*	406	358	*(48)*
Recurring revenue	**$1,362**	**$1,434**	***$72***	**$1,301**	**$1,272**	***($28)***
Reciprocal compensation	107	119	*12*	0	0	*0*
Settlement / termination	15	20	*5*	0	0	*0*
Total revenue	**$1,484**	**$1,573**	***$89***	**$1,301**	**$1,272**	***($28)***
Reported Comms. EBITDA	**$384**	**$405**	***$21***	**$304**	**$262**	***($41)***
Reciprocal compensation	(107)	(119)	*(12)*	0	0	*0*
Settlement / termination	(15)	(20)	*(5)*	0	0	*0*
Property tax benefit	0	(4)	*(4)*	0	0	*0*
Non-cash compensation	(45)	(41)	*4*	(49)	(38)	*11*
FGP recurring Comms. EBITDA	**$217**	**$221**	***$4***	**$254**	**$224**	***($30)***
Information Services EBITDA	33	40	*8*	34	44	*10*
Coal mining & other EBITDA	10	12	*2*	12	13	*1*
Reported Consolidated EBITDA	**$426**	**$457**	***$31***	**$350**	**$319**	***($31)***
Free Cash Flow (CFFO - capex)	**($277)**	**($252)**	***$25***	**($340)**	**($377)**	***($37)***

Source: Company data and Fulcrum Global Partners LLC estimates.

Please contact your Fulcrum salesperson for a copy of our full earnings model.

APPENDIX A: Note published on August 10, 2004 for Private Distribution

PRIVATE DISTRIBUTION

fulcrum GLOBAL PARTNERS®

INDEPENDENT RESEARCH

LVLT: Reality vs. Perception

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Level 3 Communications# (LVLT, $2.77, NASDAQ, SELL) **August 10, 2004**

 # Fulcrum Global Partners LLC makes a market in this security.

Decision Points:

- **The devil is in the details of the 10-Q** – Last night Level 3 released their 10-Q, and as was the case with Talk America in the second quarter, what was provided to investors in the dressed up press release was significantly different than what was provided to the SEC. With an SEC-provided disclosure that is materially different from that provided to investors in what appeared to be a very attractive press release two weeks ago, it is clear that we were simply misguided in suggesting that Level 3's reported Communications EBITDA of $79 million was ahead of our total Communications EBITDA for 2Q04 of $77 million. In fact, based upon even Level 3's most generous definition of EBITDA, it would appear as if the company missed our $77 million estimate in the quarter by $12 million with adjusted EBITDA (adjusted the way Level 3 generously defines EBITDA) of only $65 million. Even though we believe that what we thought to be nothing short of a massive miss of estimates was actually a significant incremental negative for the company and investors, we feel the simple act of yet again failing to disclose material adverse events in the company's presentation materials (that are only discovered upon sifting through SEC filings) is more than enough to show that what investors perceive this company to be, and what the reality actually is, are two very different things.

- **One-time benefits are even more significant than Talk America's** – When the company released earnings, they failed to disclose during the conference call that Communications EBITDA was aided by two major one-time benefits in the quarter from a reciprocal compensation settlement with BellSouth of $10 million and a property tax benefit of $4 million. These one-time events totaling $14 million contributed 18% of reported Communications EBITDA of $79 million. In previous quarters when these types of benefits were recognized, they were clearly disclosed in the company's earnings release, which would imply that there was a very good reason why the company did not want investors focusing on the non-recurring gains in the quarter. In short, based upon even Level 3's most generous definition of EBITDA, the company missed the quarter by a wide margin in our opinion. Unfortunately, investors were not provided with this information until yesterday, which in our opinion renders the company's quarterly conference calls meaningless.

- **3Q Guidance** – When the company released 2Q results, they issued 3Q guidance that called for a significant sequential increase in revenue and a dramatic increase in EBITDA. They attributed this improvement to a less-than-expected number of managed modem ports disconnected from AOL, and higher reciprocal compensation revenue and termination and settlement revenue, but gave no indication of how much of the expected increase was to be driven by recurring improvements in results. Their 10-Q provides further clarity:

    - Based on the company's recognition of a reciprocal compensation settlement with BellSouth in 2Q, we believe it is likely the company is expecting similar settlements with other carriers in 3Q, which would explain the expected increase in reciprocal compensation revenue from 2Q. More importantly, since reciprocal compensation revenue is 100% margin, it would also at least partially explain the dramatic increase in expected EBITDA.

    - Although the company said the AOL downturn is not expected to be as severe as expected in 3Q, in Level 3's 10-Q they disclose that they still expect AOL to disconnect 33% of their ports from Level 3 (consistent with previous guidance). This would suggest that the company simply does not expect all 33% of the ports to be disconnected in 3Q, rather the port disconnects will likely occur over time.

- **Verizon DSL contract** – The company disclosed for the first time in an SEC document that their DSL aggregation contract with Verizon expires in the first quarter of 2005 and, if not renewed, could result in a "low single-digit percentage" decline in Communications revenue in 2005. In our opinion, this appears to be the company's first attempt to signal to the Street that 2005 is likely to be the fourth consecutive "transition year" we are to witness with Level 3's results. Recall that in 2003, the company's pitch to investors was that DSL aggregation services and transport services provided to the cable MSOs would more than offset declines in the company's managed modem (dial-up) business. Now they have finally disclosed in an SEC document that what is likely their largest customer for broadband services may leave in early 2005.

APPENDIX B

IMPORTANT DISCLOSURES AND ANALYSTS' CERTIFICATIONS

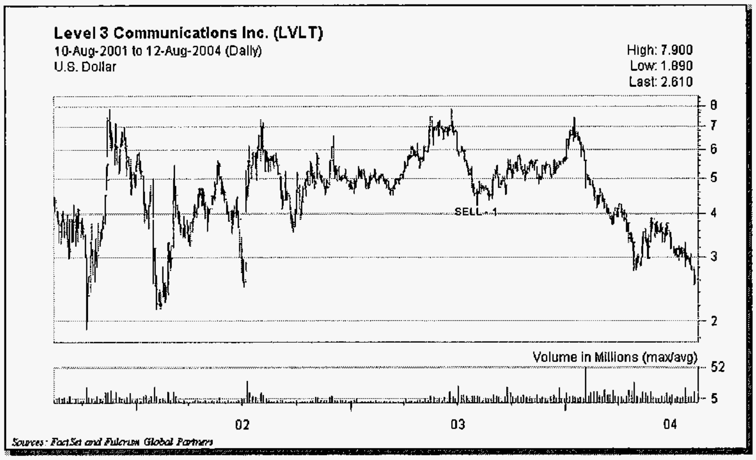
Fulcrum Global Partners LLC ratings are defined as follows:

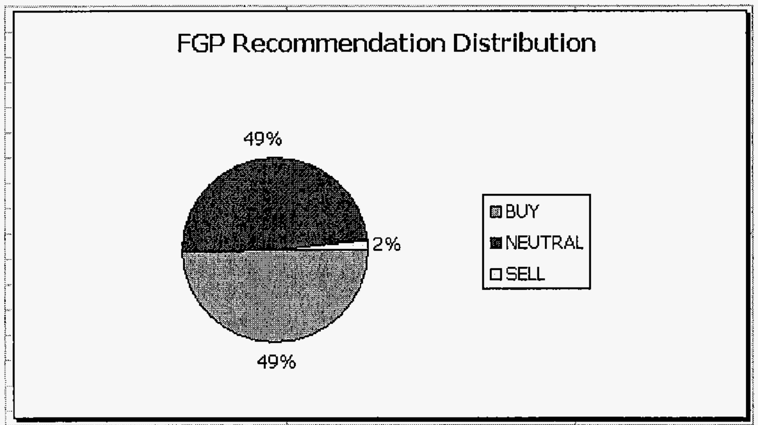
BUY – A stock that is expected at initiation to produce a positive return of 15% or greater over the 12 months following the initial recommendation. The BUY rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

SELL – A stock that is expected at initiation to produce a negative return of 15% or greater over the 12 months following the initial recommendation. The SELL rating may be maintained following initiation as long as it is deemed appropriate, notwithstanding price fluctuations that would cause the target to fall outside of the 15% return.

NEUTRAL – A stock that is not expected to appreciate or depreciate meaningfully over the next 12 months.

LVLT Price Chart (Fulcrum Ratings and Price Targets Designated)





Source: FactSet and Fulcrum Global Partners

Note: The percentage of subject companies in each rating category for which FGP has provided investment banking services within the last 12 months is 0%.

All required disclosures, including price charts, designating ratings, and price targets on all Fulcrum Global Partners LLC-rated stocks are available upon request by contacting rmenasian@fulcrumgp.com

VALUATION, PRICE TARGET METHODOLGY, RISKS TO ACHIEVING PRICE TARGET

Valuation:

- Our $1 price target is based on an EV / 2004E total company EBITDA of 12.0x.

Risk factors:

The risk to our rating and $1 price target include, but are not limited to, the following:

- The market for long-haul services suddenly improves and Level 3 achieves strong revenue growth and margin expansion over the next several quarters;
- Level 3 makes one or several acquisitions at a low cost and the acquired company (or companies) contribute meaningful EBITDA to the Level 3 income statement;
- Other competitors participate in industry consolidation, resulting in industry-wide pricing stability;
- Level 3 is acquired by another company;
- Another high profile investor makes an investment in the company, causing the stock price to rise.

Other public companies mentioned in this report:

Company	Ticker	Price	Exchange	Rating
BellSouth	BLS	$27.10	NYSE	BUY
Comcast Corp. #	CMSCA	$27.09	NASDAQ	NEUTRAL
Earthlink Inc. #	ELNK	$9.46	NASDAQ	Not Rated
ICG Communications	ICGC	$0.66	OTC	Not Rated
MCI Inc. #	MCIP	$16.24	NASDAQ	Not Rated
Talk America #	TALK	$5.97	NASDAQ	Not Rated
Time Warner Inc.	TWX	$15.86	NYSE	BUY
SBC Comm.	SBC	$25.24	NYSE	NEUTRAL
United Online #	UNTD	$11.00	NASDAQ	Not Rated
Verizon Comm.	VZ	$39.00	NYSE	BUY

#Fulcrum Global Partners LLC makes a market in this security.

ANALYST CERTIFICATION

Greg Miller and Chris Chapple hereby certify that the views expressed in this research report accurately reflect our personal views about the subject company(ies) and its (their) securities. We also certify that we have not been, and will not be, receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Unless otherwise noted, all prices are as of the close, August 12, 2004.

For additional Information, please contact your Fulcrum sales representative at (212) 803-9000.
